

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:WR: [REDACTED]: [REDACTED]:TL-N-2986-99  
[REDACTED]

date: June 20, 2000

to: [REDACTED]  
Team Coordinator  
Examination Division, [REDACTED]

from: [REDACTED]  
Attorney

subject: [REDACTED]; R&E Credit on [REDACTED] ([REDACTED] accrual)

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The attached document contains my suggestions for a Notice of Proposed Adjustment. As we discussed, it expands on the position in the draft you sent me on April 20, 2000. [REDACTED]'s claim concerns QRE on accruals for work performed by [REDACTED]

I have also returned your floppy disk, and added a copy of the suggested version of the Notice of Proposed Adjustment to the disk.

By: [REDACTED] /s/

Attorney

**Issue:**

Is the taxpayer entitled to accrue a liability for "[REDACTED]" and "[REDACTED]" done by [REDACTED] ([REDACTED]), and then treat the accrued liability as "supplies," and thus qualifying research expenditures (QRE) pursuant to section 41(b)(2)(C)?

**Facts:**

Three [REDACTED] ([REDACTED]), [REDACTED], and [REDACTED] formed [REDACTED]. [REDACTED] is a [REDACTED] Partner in the [REDACTED]. On [REDACTED], [REDACTED] and [REDACTED] entered into a [REDACTED] Contract (the "Contract"). The Contract provided the basic framework for delivery of [REDACTED] articles by [REDACTED] to [REDACTED]. A "[REDACTED]" is the total quantity of production articles necessary for one [REDACTED]. The [REDACTED] base price consisted of the following [REDACTED] manufactured [REDACTED] articles:

[REDACTED]

[REDACTED] were priced at \$[REDACTED] each, while [REDACTED] were priced at \$[REDACTED] each. Exhibit [REDACTED] provides a breakdown of these prices by [REDACTED] article.

[REDACTED] guaranteed payment for the Nonrecurring items under the Contract. See Exhibit [REDACTED], "Prices for Nonrecurring." The Nonrecurring items included:

[REDACTED]

As [REDACTED] delivered a [REDACTED], [REDACTED]'s guarantee obligation was reduced. The [REDACTED] sales price included a charge for a portion of the incurred Nonrecurring effort as well as the actual [REDACTED] cost to make the [REDACTED]. The Contract provided that "the total contract price for each

██████████ nonrecurring item shall be considered paid in full upon payment for the ██████████." See Exhibit ██████████

██████████ provided a schedule of the final ██████████ price for the above items (Attachment # ), which reflected the following dollar amounts:

██████████	in ██████████	\$ ██████████
██████████	in ██████████	██████████
Subtotal		\$ ██████████
██████████		\$ ██████████
██████████		\$ ██████████
Total	██████████ (Nonrecurring)	\$ ██████████

This schedule means that ██████████ reimbursed ██████████ for ██████████ and ██████████, but not for ██████████ & ██████████.

During ██████████, ██████████ formed ██████████ (██████████) to ██████████ the ██████████. Under the ██████████ concept, each team was responsible for an element of the ██████████ or an ██████████, and was staffed by individuals from the diverse disciplines supporting the ██████████ development process; ██████████, ██████████ and operations, procurement, customer support and other specialists. At the peak of the ██████████ effort, there were ██████████'s, some of which included representatives from suppliers and ██████████ customers. Exhibit "██████████" of the Contract describes the work that was to be performed by ██████████ in ██████████ and in ██████████ as part of the ██████████.

██████████ accrued an estimate of the monthly cost incurred by ██████████ relating to the Contract Nonrecurring effort. The accrued cost was based on estimates of the total number of ██████████ man-hours. The latter estimate was incorporated into the initial Contract in Table ██████████. ██████████ did not invoice ██████████ for its actual ██████████ hours or costs. ██████████ booked the cost estimates by debiting work-in-process ██████████

On ██████████, ██████████ filed a revision of the previously submitted ██████████ #██████████, treating the accrued Nonrecurring costs as "supplies" for purposes of computation of the research credit. The following is a detailed breakdown of the costs (through ██████████):

Year			
Year		( )	( )
	\$	\$	\$
			-
			-
Totals	\$	\$	\$

#### Law:

I.R.C. § 41(b)(2) - In-house research expenses.

(A) In general. The term "in-house research expenses" means

- (i) any wages paid or incurred to an employee for qualified services performed by such employee,
- (ii) any amount paid or incurred for supplies used in the conduct of qualified research . . .

I.R.C. § 41(b)(3) - Contract research expenses.

(A) In general. The term "contract research expenses" means 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research.

I.R.C. § 41(b)(2)(C) - Supplies. The term "supplies" means any tangible property other than -

- (i) land or improvements to land, and
- (ii) property of a character subject to the allowance for depreciation

I.R.C. § 41(d)(4) - Activities for which credit not allowed. The term "qualified research" shall not include -

(F) Foreign research. Any research conducted outside the United States.

I.R.C. § 461(a) General Rule.--

The amount of any . . . credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

I.R.C. § 461(h) Certain liabilities not incurred before economic performance.

(2) Time when economic performance occurs. Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:

(A) Services and property provided to the taxpayer. If the liability of the taxpayer arises out of

- (i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,
- (ii) the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property, or
- (iii) the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property.

**██████'s Position:**

██████ maintains that it contracted for an end product at a fixed price, and that this end product was used in the performance of qualifying research. ██████ contends that those end products are "supplies" under I.R.C. § 41(b)(2)(C).

**Service's Position:**

The Internal Revenue Service does not agree that ██████ can accrue amounts which have not been invoiced by ██████ or treat the payments as QRE. We note the following problems:

1. ██████ is treating cost estimates as QRE, even though under the economic performance rules, the costs cannot be accrued for tax purposes.
2. ██████ has accrued the costs of Nonrecurring effort. In this case, the items accrued are even described as "planning" and services". The "Effort" is either a service or, possibly, an intangible asset. However, only tangible property may qualify as "supplies". I.R.C. § 41(b)(2)(C). The only tangible property delivered to ██████

by [REDACTED] was the [REDACTED], and [REDACTED] has not explained why the [REDACTED] are supplies. (Most or all of the costs of [REDACTED] seem to be [REDACTED] costs, and not supplies.)

3. [REDACTED] is treating [REDACTED] services as QRE. Most of these [REDACTED] services were performed in [REDACTED]. If the [REDACTED] services were "research", the costs could not be QRE. I.R.C. § 41(d)(4)(F) (concerning foreign research).

4. Tooling is property of a character subject to the allowance for depreciation, and does not qualify as "supplies". I.R.C. § 41(b)(2)(C)(ii).

Each of these arguments is discussed in greater detail below.

#### **Economic Performance:**

No credit can be claimed until the year of the expenditure under its method of accounting. I.R.C. § 461(a). The economic performance rules determine whether a liability has been incurred with respect to any item. If a liability of the taxpayer arises out of the providing of property by another person, economic performance occurs as the person provides such property. I.R.C. § 461(h)(2)(A)(ii). Economic performance is deemed to occur only upon delivery because until then the taxpayer does not have use of the property.

[REDACTED] argues that the Contract provides for property, and not services (as explained below, if [REDACTED] provided services, the costs were not QRE).

[REDACTED] billed [REDACTED] for Nonrecurring effort as it delivered the [REDACTED], as provided by Article [REDACTED] of the Contract. The invoice sales price included a pro-rata share of the total Nonrecurring costs incurred. [REDACTED] accrued [REDACTED] contract costs before it had received the [REDACTED], and based the amount of the accrual on a predetermined estimate of labor.

[REDACTED] is not permitted to accrue the cost of the Nonrecurring effort until the delivery of the [REDACTED], when economic performance occurred. Costs which have not been, and cannot be accrued, are not QRE.

#### **Effort is not a Supply:**

The term "supplies" means any tangible property other than (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation.

I.R.C. § 41(b)(2)(C). [REDACTED] has included the cost of "[REDACTED]" and "[REDACTED]" effort as a supply. These items are simply costs incurred by [REDACTED] in its [REDACTED] of [REDACTED]. "[REDACTED]" and "[REDACTED]" and "[REDACTED]" effort" are services performed by [REDACTED], and are not, even in [REDACTED]'s hands, tangible property.

Perhaps [REDACTED] is claiming that the cost of the Nonrecurring items will eventually (and inevitably) be passed on to it as part of the cost of the [REDACTED]. However, [REDACTED] has not provided any justification of its treatment of the [REDACTED] as supplies, and has not explained why nonrecurring costs incurred in connection with all [REDACTED] should be treated as supplies; it cannot be true that all of the [REDACTED] are supplies (1% of the [REDACTED] were not used in prototypes, the only [REDACTED] for which [REDACTED] even argues for "supply" treatment).

#### **Foreign Research:**

As noted above, [REDACTED] appears to have performed "services" for [REDACTED]. The [REDACTED] costs incurred by [REDACTED] appear to be similar to costs incurred by [REDACTED] which [REDACTED] has included in its QRE claim pursuant to I.R.C. § 41(b)(2)(A)(i). If the [REDACTED] performed by [REDACTED] constitutes research, so does the [REDACTED] performed by [REDACTED].

[REDACTED] can only deduct the cost of services performed by an outside contractor if the services constitute contract research. I.R.C. § 41(b). However, if [REDACTED] performed research for [REDACTED] in [REDACTED], [REDACTED] cannot treat its payments for such research as QRE. I.R.C. § 41(d)(4)(F).

#### **Depreciable Property is not a Supply:**

Property of a character subject to the allowance for depreciation is not a supply for purposes of I.R.C. § 41. The only tangible property [REDACTED] delivered to [REDACTED] was the [REDACTED]. Any tangible property of a character subject to the depreciation allowance, regardless of whether the taxpayer is claiming depreciation with respect to the property, is not a supply.